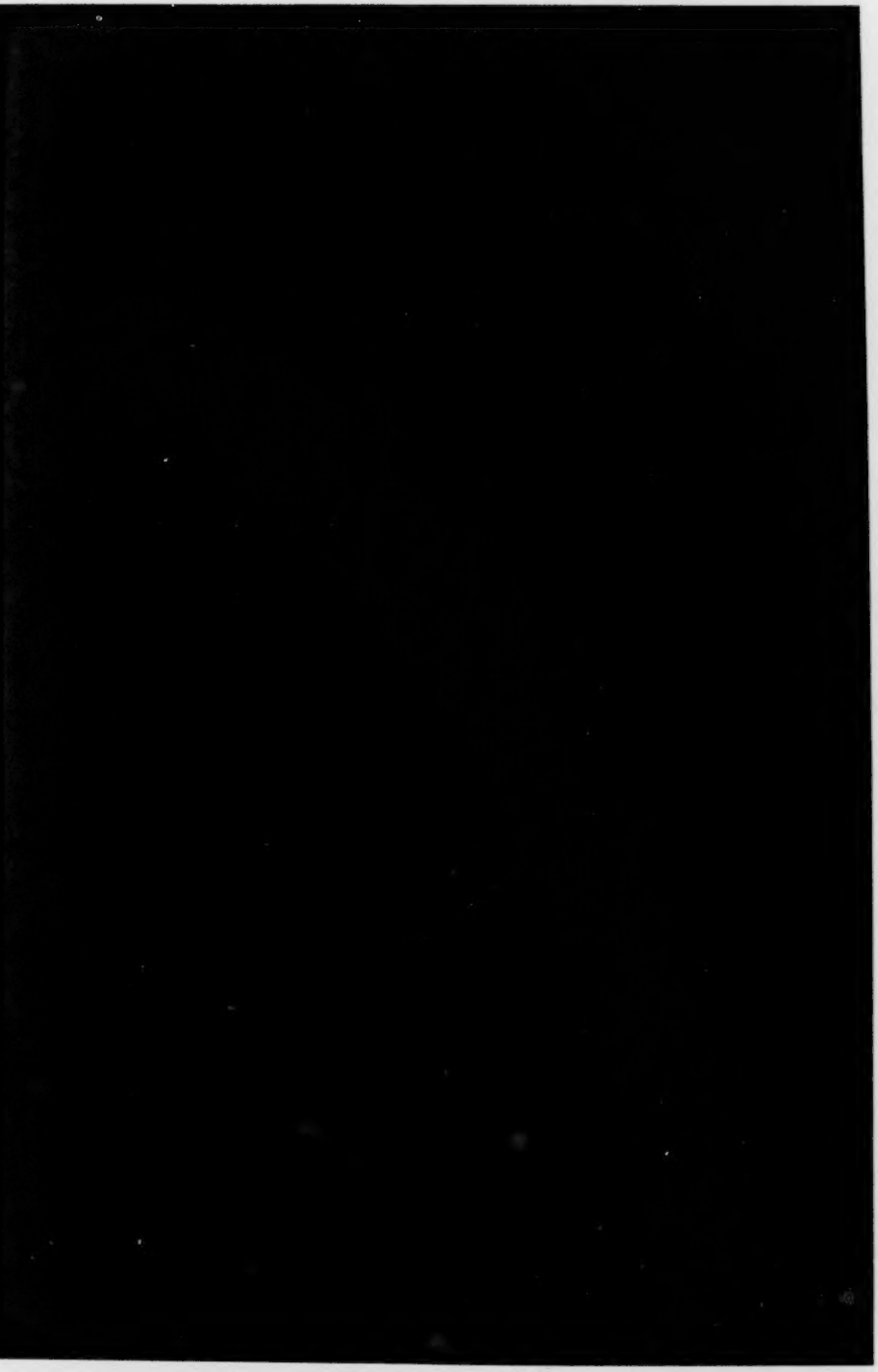

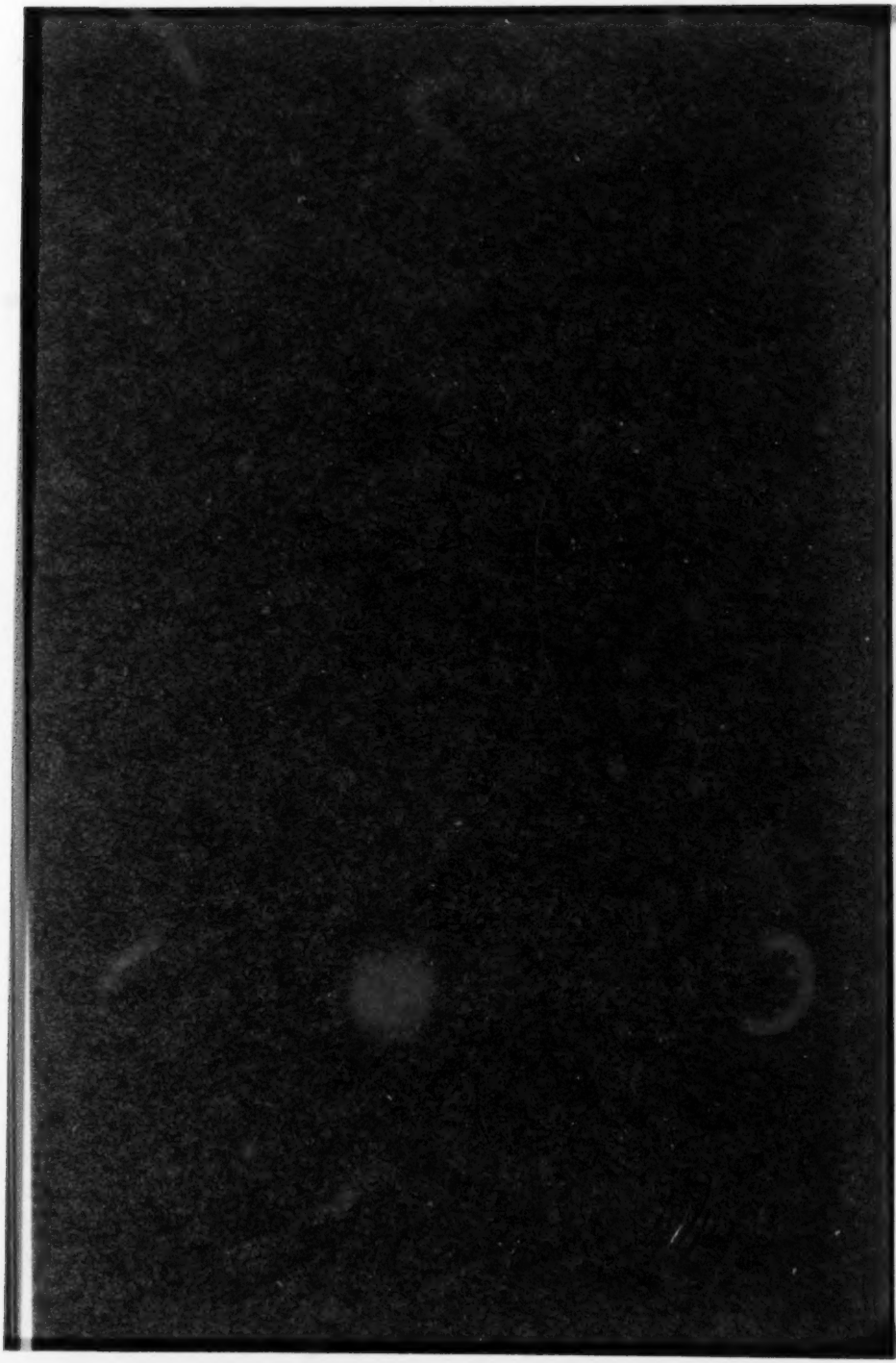

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 865

HAFENREFFER BREWING COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 23–41) is reported in 41 B. T. A. 443. The opinion of the Circuit Court of Appeals (R. 50–63) is reported in 116 F. (2d) 465.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 23, 1940 (R. 64). A petition for rehearing was denied on January 7, 1941 (R. 64). The petition for a writ of certiorari

was filed on March 22, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether in computing the taxpayer's personal holding company surtax a certain sum which was used during 1934 to retire part of the taxpayer's preferred stock, pursuant to a contract entered into in 1930, is deductible as an amount "used or set aside to retire indebtedness incurred prior to January 1, 1934," within the meaning of Section 351 of the Revenue Act of 1934 and the applicable Treasury Regulations.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra,* pp. 9–12.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 24–30) may be summarized as follows:

The taxpayer, a Massachusetts corporation organized in 1930, is a personal holding company within the meaning of Section 351 (b) (1) of the Revenue Act of 1934 (R. 24). At the time of its organization the taxpayer had a capitalization consisting of 7,000 shares of common stock of no par value and 5,900 shares of preferred stock of a par value of $100 each (R. 25).

The taxpayer's consolidated net earnings for 1933, as defined in its by-laws, were such that the taxpayer was required by the terms of a contract which it had entered into in 1930, and by the provisions of its preferred stock which it had issued in 1930, to set aside the sum of approximately $86,000 as a sinking fund for the purchase or redemption of its preferred stock. This sum was so set aside and applied to the retirement of the preferred stock during the taxable year 1934 (R. 29). Also during that year, the taxpayer paid a dividend out of its earnings of approximately $39,000 to the holders of its preferred stock (R. 29).

The taxpayer filed two federal tax returns for the year 1934, one a corporation income tax return and the other a personal holding company surtax return. In its surtax return, the taxpayer claimed as a deduction the amount which it had paid out during the taxable year in retirement of its preferred stock (R. 29–30). This deduction was disallowed by the Commissioner and a deficiency was assessed accordingly (R. 6–8). Taxpayer then filed a petition with the Board of Tax Appeals and, in an amendment to that petition, asserted that it was entitled to a deduction of approximately $39,000 in computing its income tax liability, which it had failed to assert in its return. This claim was predicated upon the dividend paid to the preferred stockholders, petitioner alleging that the dividend payment was in substance the payment of interest on indebtedness (R. 9, 30).

The Board of Tax Appeals decided that the holders of the preferred stock were stockholders rather than creditors and accordingly determined both issues in favor of the Commissioner (R. 30–39). Upon appeal, the taxpayer abandoned its claim that the $39,000 dividend payment was deductible as interest on indebtedness and pressed only its claim with regard to the $86,000 set aside for retirement of the preferred stock. The court below affirmed the decision of the Board (R. 64).

ARGUMENT

The decision of the court below that the sum set aside for the sinking fund was not "used or set aside to retire indebtedness incurred prior to January 1, 1934", within the meaning of Section 351 (b) (2) (B) of the Revenue Act of 1934, is clearly correct and is not in conflict with the decision of any other Circuit Court of Appeals.

The preferred stock plainly did not represent an "indebtedness" of the taxpayer within the meaning of the statute. The stock had no fixed maturity, a feature almost always present where there is a debtor-creditor relationship and the absence of which is persuasive evidence that no such relationship exists. *United States* v. *South Georgia Ry. Co.*, 107 F. (2d) 3, 5 (C. C. A. 5th); *Jewel Tea Co.* v. *United States*, 90 F. (2d) 451, 453 (C. C. A. 2d); *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. (2d) 11, 12 (C. C. A. 2d); *Commissioner* v. *Schmoll Fils Associated*, 110 F. (2d) 611

(C. C. A. 2d); *Finance & Investment Corp.* v. *Burnet,* 57 F. (2d) 444 (App. D. C.). Furthermore, the dividends on the stock were payable only out of earnings, a feature tending to show a capital investment rather than an indebtedness. *Finance & Investment Corp.* v. *Burnet, supra; Elko Lamoille Power Co.* v. *Commissioner,* 50 F. (2d) 595 (C. C. A. 9th); *Warren* v. *King,* 108 U. S. 389, 399; *Hamlin* v. *Toledo, St. L. & K. C. R. Co.,* 78 Fed. 664 (C. C. A. 6th); *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves,* 8 F. (2d) 716 (C. C. A. 2d), certiorari denied, *sub nom. Van Dyk* v. *Young,* 269 U. S. 570. And the rate of return on the stock was not even fixed. The rate of seven percent was to be paid for the years 1930, 1931 and 1932, but in later years the rate was seven percent or an amount representing one-half of the net earnings of the company available for dividends, whichever should be the lesser amount (R. 25).

The Treasury Regulations clearly show that such stock does not constitute an "indebtedness." Article 351–4 of Regulations 86, relating to the Revenue Act of 1934, provides in part that the term "indebtedness" means an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount; also that the term "indebtedness" does not include the obligation of a corporation on its capital stock. Since Section 351 (b) (2) (B) was reenacted in the Revenue Acts of 1936, 1937 and

1938[1] without substantial change, this Regulation must be deemed to have received legislative sanction.

There is no merit in petitioner's alternative contention that, even if the preferred stock does not constitute an indebtedness, the contractual obligation to retire some of the stock is such an indebtedness and the fulfillment of that obligation constitutes a "retirement" of the indebtedness. With respect to this contention, the court below stated (R. 56–57):

> To say that the retirement of the preferred stock is not the retirement of an indebtedness, but that the retirement of the obligation to retire the preferred is a retirement of an indebtedness does not seem reasonable. The argument would seem to involve the acceptance of the proposition that though the retirement of preferred stock is not the retirement of indebtedness, still if a board of directors should adopt an enforceable resolution providing for the retirement of certain shares, the fulfilling of the resolution would allow a deduction as the retirement of an indebtedness. Such a result seems to indicate that the argument is more ingenious than sound. Cf. *In re Piccadilly Realty Co.*, 78 F. (2d) 257, 261 (C. C. A. 7th, 1935).

It should be noted that if the taxpayer's position were sound, it would mean that, because a divi-

[1] Section 351 (b) (2) (B) of the Revenue Act of 1936, c. 690, 49 Stat. 1648; Section 355 (b) of the Revenue Act of 1937, c. 815, 50 Stat. 813; Section 405 (b) of the Revenue Act of 1938, c. 289, 52 Stat. 447.

dend declaration creates a debtor-creditor relationship between the corporation and its stockholders, the payment of the dividend could be treated as a retirement of an indebtedness and thus serve as the basis of a deduction. Even the taxpayer does not go that far; he refrains from urging that a debtor-creditor relationship arose on account of the dividend of approximately $39,000 paid on the preferred stock during the tax year.

There is no conflict with *Commissioner* v. *Tennessee Co.*, 111 F. (2d) 678 (C. C. A. 3d). In that case the taxpayer issued certain promissory notes prior to January 1, 1934, which were payable out of earnings and had no fixed maturity date. The court held that the notes evidenced an indebtedness within the meaning of Section 351 (b) (2) (B) even though the obligation was contingent.[2] In this case, the sinking fund was used to retire preferred stock, not promissory notes, and the provisions relating to the sinking fund are quite different from the terms of the promissory notes in the *Tennessee Co.* case. Moreover, in the *Tennessee Co.* case the interest rate was fixed; the rate of return in this case was not fixed. (R. 25.)

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. The case is not

[2] Apparently, the court's attention was not invited to the amended Treasury ruling (T. D. 4777, *infra*, p. 10) which expressly provided that the obligation must be absolute, and not contingent.

of general importance because it turns upon its own particular facts. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.
SAMUEL O. CLARK,
Assistant Attorney General.
SEWALL KEY,
RICHARD H. DEMUTH,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

APRIL, 1941.